THE BOND BUYER
THE DAILY NEWSPAPER OF PUBLIC FINANCE

S&P Deals California Harsh Hand

A Downgrade Plus Negative Watch

Bond Buyer | Friday, December 12, 2008

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SAN FRANCISCO - Standard & Poor's lowered California's short-term credit rating to SP-2 from SP-1 and placed $53.8 billion of long-term debt on negative Creditwatch after recent reports showed a "significant deterioration" in the state's cash position.

"California is pressured by recent sharp declines in revenue as the result of an economic slowdown," said analyst David Hitchcock. "The state should have sufficient resources to solve its projected cash shortfalls if the Legislature can reach the necessary two-thirds supermajority required for budget adjustment."

California, the nation's largest state, is struggling with a sharply slowing economy and disappointing tax collections that have pushed the budget to a $14.8 billion deficit. That's 14% of the state's $103.4 billion general fund budget for the current fiscal 2008-2009.

The deficit is expected to approach $25 billion next year. State Controller John Chiang earlier this week warned that by March California could have more payments due on a given date than it has cash available.

The lower short-term rating applies to $5 billion of revenue anticipation notes that the sate sold in mid-October. The negative Creditwatch applies to $46.6 billion of A-plus rated general obligation bonds and $7.8 billion of lease-backed debt.

California currently shares the lowest state credit rating in the nation with Louisiana, but if lawmakers don't agree to cut spending or raise taxes to solve the budget crisis soon, the Golden State could own the distinction of being the nation's least creditworthy state.

"Should the state not enact timely mid-year budget gap closing measures by February 2009, or should the state's cash position weaken significantly compared with recently revised state cash flow projections, the long-term GO and lease ratings could be lowered," Standard & Poor's said.

That would be an ironic closing to a year in which state Treasurer Bill Lockyer has waged a withering campaign against the credit rating agencies to force them to ease standards on municipal credits. He says it's unfair that Standard & Poor's holds state and local governments to higher credit standards than corporations when default rates are much lower for municipal debt than corporate debt.

But yesterday, Lockyer's spokesman declined to fault the agency for lowering the state's rating. He took aim instead at lawmakers who have failed to agree to a budget solution.

"The casualties of our fiscal fiasco continue to mount," said Tom Dresslar, a spokesman Lockyer. "It's just the latest illustration of the need for the governor and Legislature to produce a budget solution that's honest and sustainable, something the market can believe in."

He said the loss of the SP-1 short-term credit rating essentially precludes almost any further short-term borrowing and increases the need to take action on the budget right away.

In September, Lockyer ripped California's currently unbalanced budget spending plan as a "banana republic budget" that closed a deficit mostly through accounting gimmickry. Earlier this week, he told lawmakers that the state's "dire" fiscal crisis would force him to shut down infrastructure projects across the state due to lack of cash.

California lawmakers are having trouble coming up with a budget plan that can garner the necessary two-thirds supermajority to pass the Legislature. Republicans, who hold just enough seats to block a budget or tax measure, refuse to allow tax increases while the state is in a recession and taxpayers can least afford to pay more taxes.

Democrats, who hold a majority in both houses, are unwilling to balance the budget with spending cuts alone, which would require deep cuts in education and social services when the services are needed most. The Democrats last month proposed a plan that would close most, but not all, of the current gap. They wanted to split the pain evenly between tax hikes and spending cuts. Republicans defeated the plan.

Republican Gov. Arnold Schwarzenegger lashed out at both parties in a press conference Wednesday afternoon.

"California faces a growing financial crisis," he said. "If we don't set aside our ideological differences and negotiate to solve this problem, we are headed towards a financial Armageddon. We can already see it coming."

Controller Chiang released the state's latest bleak budget news earlier this week. Tax revenues for the first five months of the fiscal year were $31.5 billion. That's $1.6 billion, or 4.9%, less than expected. Personal income tax payments were 3.6% below plan, and sales and use taxes were down 6.2% compared to the budget passed in September.

With the state's economy in freefall, the numbers are deteriorating quickly. The results for November were much worse than the full five-month results. Total general fund revenue collections were down 16.6% from the November 2007 results and below budget by 18.5%, according to Chiang.

The California economy has fallen into a prolonged recession and will continue to contract through the first half of 2009, according to a UCLA Anderson Forecast released yesterday. The forecast is the most closely watched macroeconomic report on the California economy, and governments use the numbers to project revenues and spending needs.

"The forecast for the next three quarters is one of contraction in economic activity, followed by the beginning of a slow recovery," senior economist Jerry Nickelsburg said in a report. "California and other local governments are struggling with falling revenues for the 2008-2009 and 2009-2010 fiscal years and are unable to counteract this with an economic stimulus."

The state's unemployment rate jumped to 8.2% in October, the highest since September 1994, according to the California Employment Development Department. The jobless rate will jump to an average of 8.7% for 2009, peaking near 9% before beginning a slow decline in 2010, according to the UCLA forecast. Real personal incomes will drop 0.6% next year and rise only 0.9% in 2010.

"From August to November, labor markets in California changed radically," Nickelsburg said. "There are no bright spots on the horizon."

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